



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9589]

RIN 1545-BK11

Modifications to Definition of United States Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to the treatment of upfront payments made pursuant to certain notional principal contracts for U.S. federal income tax purposes. The temporary regulations provide that certain obligations of United States persons arising from upfront payments made by controlled foreign corporations pursuant to contracts that are cleared by a derivatives clearing organization or clearing agency do not constitute United States property. These regulations affect United States shareholders of controlled foreign corporations that make such payments. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking (REG-107548-11) on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date. These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date. These regulations apply to payments described in §1.956-2T(b)(1)(xi) made on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

FOR FURTHER INFORMATION CONTACT: Kristine A. Crabtree at (202) 622-3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

A. Section 956

Section 956 was enacted to require an income inclusion by United States shareholders (as defined in section 951(b)) of a controlled foreign corporation (as defined in section 957(a)) that invests certain earnings and profits in United States property (U.S. property) "on the grounds that [the investment] is substantially the equivalent of a dividend being paid to them." S. Rep. No. 87-1881, 1962-3 CB 703, 794 (1962). Under section 951(a)(1)(B), each United States shareholder (U.S. shareholder) of a controlled foreign corporation (CFC) is generally required to currently include in its gross income the amount determined under section 956 with respect to such shareholder.

The amount determined under section 956 with respect to a U.S. shareholder of a CFC for any taxable year is the lesser of: (1) the excess, if any, of the shareholder's pro rata share of the average of the amounts of U.S. property held (directly or indirectly) by the CFC as of the close of each quarter of such taxable year, over the amount of earnings and profits of the CFC described in section 959(c)(1)(A) with respect to such shareholder; or (2) the shareholder's pro rata share of the applicable earnings of the

CFC. In general, the amount taken into account with respect to any U.S. property for this purpose is the adjusted basis of such property as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject. Earnings and profits described in section 959(c)(1)(A) are attributable to amounts previously included in gross income by the U.S. shareholder under section 951(a)(1)(B) (or which would have been included except for section 959(a)(2)).

Section 956(c)(1) defines U.S. property to generally include stock of a domestic corporation and an obligation of a United States person (U.S. person). Section 956(c)(2), however, generally excludes from the definition of U.S. property the stock or obligations of a domestic corporation that is neither a U.S. shareholder of the CFC nor a domestic corporation, 25 percent or more of the total combined voting power of which, immediately after the CFC's acquisition of stock in such domestic corporation, is owned, or is considered as being owned, by U.S. shareholders of the CFC. Under §1.956-2T(d)(2), subject to certain exceptions not relevant here, the term “obligation” includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest.

B. NPCs with Nonperiodic (Upfront) Payments

When a notional principal contract (within the meaning of §1.446-3(c)(1)) (NPC) includes a significant nonperiodic payment, the contract is generally treated as two separate transactions. One transaction is an on-market, level payment swap; the other is a loan. For purposes of section 956, the Commissioner may treat any nonperiodic payment in connection with an NPC, whether or not it is significant, as one or more

loans. See §1.446-3(g)(4). If a party to an NPC makes below-market periodic payments or receives above-market periodic payments under the terms of the contract, typically that party will make a nonperiodic payment, such as an upfront payment, to the counterparty in order to compensate for the off-market coupon payments specified in the contract.

For example, if A and B enter into an off-market interest rate swap the terms of which require A to make periodic below-market fixed rate payments to B and require B to make periodic on-market floating rate payments to A, then A typically will compensate B (for receiving the below-market fixed rate payments) by making a nonperiodic payment at the outset of the interest rate swap (henceforth, an upfront payment) so that the present value of the fixed rate leg of the swap will equal the present value of the floating rate leg of the swap.

Recently, certain contracts (cleared contracts), including some credit default swaps and interest rate swaps, have begun to be cleared through U.S.-registered derivatives clearing organizations or clearing agencies (collectively, U.S.-registered clearinghouses). Contracts cleared through a U.S.-registered clearinghouse generally are required to have standardized terms. For example, credit default swaps that are cleared through a U.S.-registered clearinghouse have common documentation and standardized coupons (currently 100 or 500 basis points). Consequently, except for the rare instance when the market coupon rate for a particular credit default swap is exactly 100 or 500 basis points, a credit default swap with a standardized coupon will be off-market and will require an upfront payment to equalize the present value of the payment obligations under the contract.

The volume of contracts cleared by U.S.-registered clearinghouses is expected to increase substantially as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law No. 111-203, 124 Stat. 1376 (the Dodd-Frank Act). Title VII of the Dodd-Frank Act, among other things: (1) provides for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposes clearing and trade execution requirements on many swap contracts; and (3) creates rigorous recordkeeping and real-time reporting regimes.

C. Clearinghouse Margin Requirements to Manage Credit Risk

U.S.-registered clearinghouses manage credit risk (the risk of counterparty default) in part by requiring that each party to a cleared contract provide various types of margin, including initial variation margin and daily variation margin (both of which are discussed in this section of the preamble). Cash margin payments (as well as other payments made pursuant to the terms of a cleared contract) to and from a U.S.-registered clearinghouse are made to or through a clearing member (that is, a futures commission merchant, broker, or dealer who is a member of the clearinghouse) which, in turn, makes corresponding payments to or receives corresponding payments from a counterparty.

(1) Initial Variation Margin Required to Offset Upfront Payment

The party that makes an upfront payment pursuant to a cleared contract (the first party) has credit risk with respect to that payment because, if the clearinghouse (or the first party's clearing member) were to default, the first party would not receive the full benefit it paid for (the benefit of making below-market fixed rate payments or receiving above-market payments for the term of the contract). When the U.S.-registered

clearinghouse makes the upfront payment to the other party to the cleared contract (the second party), the U.S.-registered clearinghouse similarly has credit risk with respect to that second party (or its clearing member). The second party (the ultimate recipient of the upfront payment) is thus required to make a payment in the nature of variation margin (initial variation margin) to the U.S.-registered clearinghouse, generally no later than the end of the business day on which the upfront payment is made, in an amount that is equal to the upfront payment.

In some instances, the total amount of margin posted by the second party on the day that it is required to post initial variation margin may not equal the amount of the first party's upfront payment, due to either: (1) the netting of the second party's notional exposure to the first party, or to the clearinghouse, as a result of other transactions; or (2) changes in the value of the contract between the time the contract is entered into and the time when the required margin is paid, requiring daily variation margin to be added to or subtracted from the second party's initial variation margin payment, as the case may be. However, on a transaction-by-transaction basis, the payment of initial variation margin by the second party should equal the first party's upfront payment when any daily variation margin is treated as separate from the initial variation margin posted on that day.

After receiving the second party's initial variation margin payment, the U.S.-registered clearinghouse will pay the same amount to the first party. In each case, unless the first party and the second party are clearing members of the U.S.-registered clearinghouse, the payment will be made to or through each party's clearing member, which may be an affiliate of that party.

Assume that D (a dealer under section 475) and C (a customer) enter into a contract that is accepted for clearing by a U.S.-registered clearinghouse, the terms of which require D to make below-market periodic payments to C. D is required under the contract to make an upfront payment of \$25,000 to compensate C for the below-market coupon payments that C will receive. D (not a clearing member) makes that upfront payment to its clearing member, who then pays the U.S.-registered clearinghouse an identical amount. The U.S.-registered clearinghouse in turn pays that amount to the clearing member for C, which makes the upfront payment to C. C, on the same business day, makes an initial variation margin payment of \$25,000 to its clearing member, who then pays that amount to the U.S.-registered clearinghouse; the U.S.-registered clearinghouse makes the initial variation margin payment to D's clearing member; and D's clearing member makes the payment to D. Thus, the upfront payment from D is immediately offset by an initial variation margin payment in the same amount from C.

(2) Daily Variation Margin Required to Account for Daily Market Fluctuation

In addition to initial variation margin, U.S.-registered clearinghouses manage credit risk by requiring that each party to a cleared contract provide daily variation margin (also referred to as mark-to-market or maintenance margin). Daily variation margin is a cash margin payment made on a daily or intraday basis between the counterparties to a contract to protect against the risk of counterparty default. The rules of U.S.-registered clearinghouses generally require that daily variation margin be paid in an amount equal to the change in the fair market value of the contract.

Explanation of Provisions

The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register**. These temporary regulations establish an exception to the definition of U.S. property for obligations of U.S. persons arising from upfront payments made with respect to certain cleared contracts that are properly classified as NPCs. The temporary regulations provide that obligations of U.S. persons arising from such upfront payments by a CFC that is a dealer in securities or commodities (within the meaning of section 475) do not constitute U.S. property for purposes of section 956(a).

To qualify for this exception: (1) the upfront payment must be required under a contract that is cleared by a derivatives clearing organization (as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a)) or a clearing agency (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)) that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively; (2) the CFC must make the upfront payment to or through a United States person that is a clearing member of the derivatives clearing organization or clearing agency, or directly to the derivatives clearing organization or clearing agency if the CFC is a clearing member of such derivatives clearing organization or clearing agency; (3) the upfront payment must be made, directly or indirectly, to the counterparty to the contract; (4) the counterparty to the contract must be required to make a payment in the nature of initial variation margin that is equal (before taking into account any change in the value of the

contract between the time the contract is entered into and the time at which the payment is made) to the amount of the upfront payment made by the CFC; and (5) such payment in the nature of initial variation margin must be paid, directly or indirectly, to the CFC.

The IRS and the Treasury Department do not believe that an obligation of a U.S. person created by an upfront payment resulting from a cleared contract that satisfies the requirements listed in this regulation is the type of transaction intended to be covered by section 956, whether or not the payment is treated as a loan under the NPC rules under section 446. While the section 956 exception in these temporary regulations currently is limited to cleared contracts, the IRS and the Treasury Department continue to study, and request comments on, whether and under what circumstances it would be appropriate to extend the exception to contracts that are not cleared by a U.S.-registered clearinghouse, but that would otherwise meet the criteria set forth in these temporary regulations.

Effective/Applicability Date

These regulations apply to payments described in §1.956-2T(b)(1)(xi) made on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. However, taxpayers may apply the rules of these regulations retroactively to payments made prior to **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not

required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the cross-reference notice of proposed rulemaking published in the proposed rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small entities.

Drafting Information

The principal author of these regulations is Kristine A. Crabtree of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1-- INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.956-2T(b)(1)(xi) also issued under 26 U.S.C. 956(e). * * *

Par. 2. Section 1.956-2 is amended by adding a new paragraph (b)(1)(xi) to read as follows:

§1.956-2 Definition of United States property.

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(b) * * *

(1) * * *

(xi) [Reserved]. For further guidance, see §1.956-2T(b)(1)(xi).

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Par. 3. Section 1.956-2T is amended by:

1. Revising paragraphs (a) through (d)(1).
2. Adding new paragraphs (f) and (g).

The revisions and additions read as follows:

§1.956-2T Definition of United States property (temporary).

(a) through (b)(1)(x) [Reserved]. For further guidance, see §1.956-2(a) through (b)(1)(x).

(xi) An obligation of a United States person arising from an upfront payment by a controlled foreign corporation (within the meaning of section 957(a)) with respect to a notional principal contract (within the meaning of §1.446-3(c)(1)) where the following conditions are satisfied—

(A) The controlled foreign corporation that makes the upfront payment is a dealer in securities or commodities (within the meaning of section 475(c)(1) or (e)(1));

(B) The upfront payment is required under a contract that is cleared by a derivatives clearing organization (as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a)) or a clearing agency (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)) that is registered

as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively;

(C) The controlled foreign corporation makes the upfront payment:

(1) To or through a United States person that is a clearing member of a derivatives clearing organization or clearing agency, or

(2) Directly to the derivatives clearing organization or clearing agency if the controlled foreign corporation is a clearing member of such derivatives clearing organization or clearing agency;

(D) The upfront payment is made by the derivatives clearing organization or clearing agency, directly or indirectly, to the original counterparty to the contract;

(E) The original counterparty to the contract that receives the upfront payment, as described in paragraph (b)(1)(xi)(D) of this section, is required by the derivatives clearing organization or clearing agency to make, by the end of the business day on which the upfront payment is made by the controlled foreign corporation, a payment in the nature of initial variation margin that is equal (before taking into account any change in the value of the contract between the time the contract is entered into and the time at which the payment is made) to the amount of the upfront payment and such payment is made, directly or indirectly, to the derivatives clearing organization or clearing agency; and

(F) The payment in the nature of initial variation margin is paid by the derivatives clearing organization or clearing agency, directly or indirectly, to the controlled foreign corporation.

(G) Examples. The following examples illustrate the application of this paragraph

(b)(1)(xi):

Example 1. CFC is a controlled foreign corporation that is wholly owned by USP, a domestic corporation. CFC is a dealer in securities under section 475(c)(1). CFC enters into a credit default swap (that it treats as a notional principal contract for U.S. federal income tax purposes) with unrelated counterparty B. The credit default swap is accepted for clearing by a U.S.-registered derivatives clearing organization (DCO). CFC is not a member of DCO. CFC uses a U.S. affiliate (CM), which is a member of DCO, as its clearing member to submit the credit default swap to be cleared. CM is a domestic corporation that is wholly owned by USP. The standardized terms of the credit default swap provide that, for a term of X years, CFC will pay B a fixed coupon of 100 basis points per year on a notional amount of \$Y. At the time CFC and B enter into the credit default swap, the market coupon for similar credit default swaps is 175 basis points per year. To compensate B for the below-market annual coupon payments that B will receive, the contract requires CFC to make an upfront payment through CM to DCO. DCO then makes the upfront payment to B through B's clearing member. DCO also requires B to post initial variation margin in an amount equal to the upfront payment. B pays the initial variation margin through its clearing member to DCO. DCO then pays the initial variation margin through CM to CFC. Because the conditions set out in this paragraph (b)(1)(xi) are satisfied, the obligation of CM arising from the upfront payment by CFC does not constitute United States property for purposes of section 956.

Example 2. Assume the same facts as in Example 1, except that counterparty B is, like CM, a domestic corporation that is wholly owned by USP. Because the conditions set out in this paragraph (b)(1)(xi) are satisfied, the obligations of CM and B arising from the upfront payment by CFC do not constitute United States property for purposes of section 956.

Example 3. Assume the same facts as in Example 2, except that CFC uses an unrelated person as its clearing member. Because the conditions set out in this paragraph (b)(1)(xi) are satisfied, the obligation of B arising from the upfront payment by CFC does not constitute United States property for purposes of section 956.

(b)(2) through (d)(1) [Reserved]. For further guidance, see §1.956-2(b)(2)

through (d)(1).

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(f) Effective/applicability date. Paragraph (b)(1)(xi) applies to payments described in §1.956-2T(b)(1)(xi) made on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. Taxpayers may apply the rules of paragraph (b)(1)(xi) to payments described in §1.956-2T(b)(1)(xi) made prior to **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

(g) Expiration date. The applicability of paragraph (b)(1)(xi) expires on [Friday, May 8, 2015](#).

Steven T. Miller

Deputy Commissioner for Services and Enforcement.

Approved: May 1, 2012

Emily S. McMahon

Acting Assistant Secretary of the Treasury (Tax Policy).

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